FIRST New England
federal credit union

Your Partner in Achieving Financial Success

March 16, 2009

Ms. Amy Rupp
Secretary of the Board, NCUA
1775 Duke Street
Alexandria, Virginia 22314
RE: 12 CFR Part 704 Corporate Credit Unions

Dear Ms. Rupp,

I am writing in response to NCUAs request for comments regarding proposed rules for corporate credit unions. My career has been personally / professionally intertwined with two corporates for over 15 of my 25 years in the movement. The credit unions I have worked in have always been strong supporters of the corporate network and First New England's response is to continue to support a viable network.

From my experience the key operating expense drivers in corporates are payment systems, higher level investment functions, and risk management. A thorough analysis will likely indicate that the current system is broken due to key flaws in the business model relating to expenses, risk, and the management of them. There is unwarranted and misplaced emphasis on payment systems that has been a significant contributor to investment margin pressures and the taking of extended credit risk.

Recent losses incurred to refund the system result predominantly from the largest corporates and the expense imbalances, though widespread, are also dominated in the aggregate by the largest. The smaller corporates have representatives that appear to be in even more distress as well as several that are better positioned. The solutions with regard to the smaller corporates should come only after the examination of the larger corporates that are driving most of the losses and systemic risk in the system.

With this in mind it is appropriate that NCUA reexamine the business models of the entire corporate network. The scope of existing losses along with the uncertainty in determining the total loss exposure are such that an open ended commitment to the existing system could jeopardize natural person credit unions (NPCUs). This is unacceptable unless a new model is implemented or the losses can be capped.

Expense structures appear to be out of line with conservative management principles. Instead of economies of scale, the existing model has instead produced "larger losses", growth of the balance sheet by building ever larger asset positions, and a threat to the health of natural person credit unions. The margin management pressures and resulting inappropriate responses by the corporates lead us to conclude that a much simpler organizational / liquidity structure and new approach to payment systems is warranted. If restructured, an opportunity exists to include a new era core liquidity focus; creating a credit union specific secondary markets for loans for the core products of natural person credit unions.

The responses in the attached ANPR support this contention and are submitted on behalf of First New England Federal Credit Union, East Hartford, CT.

Respectfully,

Michael Palladino
President / CEO
First New England Federal Credit Union

March 18, 2009

Summary of NCUA's Advance Notice of Proposed Rulemaking for Corporate Credit Unions

Issue for Consideration Not Identified in ANPR

The recommended solutions in this ANPR are critically dependent on identifying the financial scope of the problem NPCUs are facing. Admittedly that is not an easy task, but this credit union is not supportive of the corporate network if that entails an open ended commitment that cannot be quantified with some measure of transparency. To do so would be in violation of the fiduciary responsibilities we have to our Board of Directors and members. I believe the answers to the ANPR questions would differ markedly if the scope of the problem expanded significantly beyond those already disclosed.

An effective solution that could provide the needed transparency and accountability would be to provide the corporate system with CLF access and a limited change to mark to market as suggested by the FHLB presidents in their 12-29-2008 letter to the FASB. With these changes the focus would shift more to credit losses and less on an illiquid market. The corporates and NCUA would be positioned with the proper mechanisms to deal fairly and effectively with the OTTI issues. Action would be forced in conjunction with CPA firms where insolvencies exist and sustainable and unsustainable corporates would be identified promptly. With these revised "mark to market" rules in force, natural person credit unions would have a way to quantify the scope of the exposures without an undue reliance on NCUA as the ultimate "cooperative arbiter" and architect of the eventual corporate solution. In addition I would urge the NCUA to support provisions that will allow up to five years restoring the NCUSIF capital ratio to the statutory 1.2 percent level.

NCUAs current approach does not balance the consequences mandated between the corporates, who took the undue risk, and the natural person credit unions funding the losses, that did not. NCUA's current solution imposes the overwhelming immediate burden (and its implied lack of fairness) on natural person credit unions; without placing any simultaneous corresponding burden on the group responsible for the problem: the corporates. Following the course of action recommended in this response would correct this imbalance and reshape a more efficient scaled down system.

Issues for Consideration Identified in ANPR

1. **Role of Corporates in the Credit Union System**

With this ANPR, NCUA is considering many comprehensive changes. Specific areas where NCUA is soliciting comment include:

Payment Systems

- Should payment system services be isolated from other corporate services to separate risk? If so, what is the best structure for doing so?
- Would it be better to establish a charter for corporate credit unions whereby a corporate's authority is strictly limited to operating a payment system?
- Should legal and operational firewalls be established between payment system services and other services?

It is appropriate that this is the first question because this seems to be the exact prioritization that many corporates give to payment systems to the ultimate detriment of system. This is an inherent danger in the current system and it is a critical question to be addressed. It is amazing that corporates to this day do not have stringent cost accounting in place for this line of business. The largest corporates are included among these and talk about payment services as a "vital core service". Upon further investigation I believe you will find that unless substantially modified, they should not be.

Our credit union has been direct with the Federal Reserve for over 15 years since we were 18 million in assets. We have used multiple corporate services during this time from two different corporates. Recently we acted to implement Check 21 simultaneously moving payment systems from the Fed to our local corporate. The assumption was that corporates deliver a higher level of service and the financial analysis showed that the costs would be similar. But in retrospect with regard to payment systems, we would have been better off having gone through our data processor for Check 21 while setting up an alternative clearing agent. The service with regard to payment systems at both the corporates has been less than that provided when we were direct with the Fed. This is not to say that our corporates overall do not provide good service, they do. In short, the point is that corporates do not provide substantial value here for any but the very smallest credit unions that do not pay proportionately for the service they do get.

Relating this back to the corporate business model, payment services should not be considered as an essential core business unless the pricing of this service fully supports the entire line of business. If the service has been used as a loss leader that is an indication of a misguided sense of philosophy that has endangered the real core mission; providing liquidity. Times change and especially with regard to the larger corporates, it is dangerous that they have not changed to clearly identify the costs of this line of business and implement alternatives. "Economies of scale" have not overcome the fact that they are losing money on the service. More volume in that case only further magnifies a poor business decision.

Consider an analogy that natural person credit unions have faced. Checking was once considered a core service and used effectively as a loss leader. But the world changed over the course of 25 years and that old checking approach became less competitive versus banks that used an increased reliance on fee income to offer a better total package over time. Rather than staying with a less competitive core product that members would not pay more for, we questioned our assumption that we offer this "core" service "as is". With changes to the external world, we changed to redesign / re-price checking in such a way that it now is significantly expanding our market share at the same time it is making, not losing money. Members benefit and we benefit but only after a significant redesign of the "core" product. If we had the foresight to adapt, it should indicate that a corporate with many times our resources should have been able to.

This suggests that there is a combination of poor management and or governance at the staff and Board levels involved in this misguided reliance on payment systems as money losing core service. Thus, in any scenario where payment systems are continued, a critical change that would ensure more transparency is to mandate rigid cost accounting for payment systems to disclose the true cost to members. As part of this cost accounting analysis consider the extensive allocation of sales and other administrative staff involved in this function, not just the immediate staffing in that area. This analysis will likely show that payment services are not a viable business. In fact this line of business and investment decisions has put undue pressure on the margin management side of the investment business, thus increasing risk.

Separate charters do not seem indicated for these services. If the NCUA and Corporates believe this is a viable stand alone business I would instead advocate that payment services be offered by one central CUSO that utilizes other corporate on the local level in a scaled down network. The liquidity solution for payment services now in place needs to be adapted to a new CUSO model or discontinued.

Liquidity and Liquidity Management

- Should liquidity be considered a core service of the corporate system? If so, what steps should be taken to preserve a corporate's ability to offer that service?
- Should NCUA add aggregate cash flow duration limitations to Part 704? If so, how should it be structured and how would such limitations benefit liquidity management?
- What cash flow duration limits would be appropriate for corporate credit unions?

As others who where there at the start of the corporate system have attested to; this is at the heart of why the corporate network was founded. If that function cannot be provided in a safe limited manner, then why have a corporate? Bankers Banks (http://www.bankersbankusa.com/index.asp?page=1927)have a much more limited function acting as an intermediary providing liquidity as a pass through agent while taking a cut. The point is that there are alternatives that involve a radically reduced expense structure. They should be explored seriously as an alternative to the heavily laden staffing requirements in place today.

While I do not have the expertise to comment on the detailed structure that would be needed to maintain the level of current services provided, it is imperative that new models be explored since this one has been in decline for quite some time. Margin management pressures must be reduced and if more complexity is needed then given the performance of both NCUA in its oversight role and the corporate themselves it seems a simpler model should be put in place. At heart our movement's strength is providing basic core services to members. If we cannot provide a liquidity solution without PHDs to understand it, then we are probably off course with that solution.

But since liquidity is "the core function" of corporate it seems that there are significant opportunities that are being missed to help natural person credit unions. Securitization and participation markets have been dominated in the past outside of our movement. But with the recent collapse of these structures it seems there is a significant opportunity to create a better set of liquidity solutions for all credit unions on our core products; real estate, autos, and charge cards. I would advocate combining the largest corporates into one central corporate and charge them with a new mission to replace payment systems: create credit union specific secondary markets starting with mortgages. The country is in desperate need of better solutions here.

By committing the combined resources of the largest corporates to form a new Credit Union Secondary mortgage market, their skills and sophistication could be used to build a new core product support system that fits with our mission. The opportunity is huge and the time is now because the only significant secondary market option left is the government. The success models within our movement are there. So shape a credit union solution like the FHLB model but with our own nationwide participation network. Work with the government agencies to drive down costs and fill a market void that is sorely needed.

While competing in the loan area has been ceded to the FHLBs due to competitive advantages that the corporates could not match, their mortgage model is one to emulate because they were the one agency that stuck to its guns in requiring partner originators to share a portion of the risk on every loan originated throughout this whole mess. That is a mortgage model that deserves consideration.

Field of Membership Issues

- Should the ability of corporates to accept members from a national field of membership be eliminated? Should corporates be required to return to defined fields of membership, i.e. state or regional FOMs?

Field of membership expansions led to competition which contributed to margin pressures. But it seems that the issues here were more to do with the problems noted above in the liquidity and payment systems areas. While we are not sure that change is needed but it should be analyzed versus more limited regional fields of membership. In either scenario we should keep satellite operations in the consolidated corporates. Any new model pursued will likely be unsustainable in the future if it does not require substantial consolidation via the use of centralized CUSO operations or regional consolidation.

An alternative to limiting Corporates' FOM is to require that all NPCUs capitalize any Corporate that they utilize for investment purposes. The capital requirements will cause NPCUs to make investment decisions and increase the capital level in Corporate's. Underperforming Corporates will liquidate or merge to meet members' needs. This is a much more "market driven" response than limiting Corporate's FOMs.

Expanded Investment Authority

- Should the expanded investment authority option for corporate credit unions continue?
- If so, should NCUA modify the procedures and qualifications, i.e. higher capital standards, by which corporates currently qualify for expanded authorities? What would such standards be?
- Should the amount of expanded authorities available be reduced?

Investment authorities should be aligned with greater capital requirements as greater risk requires greater controls, monitoring and greater capital. With the current model it is impossible for the corporates to survive without expanded authority and more, not less, diversification alternatives. Given the current system, that would be inviting further problems. Thus I would favor either moving to a Bankers bank limited solution (see liquidity section on previous page) or scaling down this expanded authority to only a handful of corporate serving as CUSOs if that could be worked out safely by the corporates and NCUA.

Well over 5 years ago most of the Boards and CEO's of corporates knew margin management would continue to decline in the era of commoditization and that their models were in peril. Yet they stayed with a model with poor long term prospects while dabbing in technology and CUSOs. They also had **rapidly rising infra structure out of line with the core business strength**. There were basic business choices that needed to be confronted. Do we cut expenses to be proportionate to the core model, take on more risk in margin management, or increase noninterest income through a new model? My take is that a combination of these approaches was tried "tinkering at the edges" while paying lip service to the new model ideas. In reality they were taking on more margin management risk with NCUA blessing via financial engineering. The scenario reminds us of the banks who again are seeking a bailout.

<u>Structure: 2-Tiered System</u>
Retail and Wholesale

- Does the current two-tiered system meet the needs of credit unions?
- Is a wholesale corporate credit union necessary? If so, what should its primary role be?
- Should there be a differentiation in powers between retail and wholesale corporates?
- Should the capital requirements be the same between wholesale and retail corporate credit unions?

Others have made the point effectively and the listed the reasons. Eliminate this two tiered system.

2. **Corporate Capital**

<u>Core Capital</u>

- Should NCUA establish a new capital ratio that corporates must meet consisting of only core capital and if so, at what level?
- What is an appropriate measure of core capital?
- Should a corporate be limited to offering its services only to members maintaining contributed core capital with the corporate?

Primary funding should be composed of retained earnings but a continued NCUA guarantee will be needed given the near term environment and the unspecified risk exposure we would be taking.

<u>Membership Capital</u>

- Should membership capital be permitted in its current configuration? Should it be modified?
- Should NCUA eliminate or modify certain features such as the adjustment feature, so that membership capital meets the traditionally accepted definition of tier two capital?
- Should adjusted balance requirements be tied only to assets as currently provided? Should limits be imposed on the frequency of adjustments?
- Comment is also requested on whether NCUA should consider revisions to the definition and operation of membership capital.

Since corporate credit unions have limited memberships, membership capital should be mandatory and the formula for how much should be the same across the board. The competitive battles for market share led to "voluntary" membership capital status that has weakened the corporate financial position. Perhaps a secondary market to sell this capital could also be created in a revised structure.

<u>Risk-Based Capital and Contributed Capital Requirements</u>

- Should NCUA consider risk-based capital for corporates consistent with that currently required of other federally regulated financial institutions? If so, what statutory or regulatory changes would be required to do so?
- Should a natural person credit union be required to maintain a contributed capital account with its corporate as a pre-requisite to obtaining services from the corporate?
- Should contributed capital be calculated as a function of share balances maintained with the corporate? Should asset size be used n this calculation?

Risk based capital is appropriate, particularly in the case of expanded authority so that more capital will be required of corporates that have higher authorities.

3. **Permissible Investments**

NCUA is considering whether corporate investment authorities should be constrained or restricted. To that end, they seek comment on the following:

- Should corporate investments be limited to those allowed for natural person credit unions?
- Should specific categories of investment be prohibited such as collateralized debt obligations, net interest margins and subprime and ALT-A asset backed securities?
- Should NCUA modify existing permissibility or prohibitions for investments?

See above answer. If the system is continued as is coporates will need more authorities and that is why I advocate a simplified model. The NCUA also will need more resources in this area if it is continued as is. Hiring outside consultants with greater expertise related to sophisticated investment management should be a permanent solution that will help assure adequate oversight in the future.

4. **Credit Risk Management**

- NCUA is seeking comment on whether it should require more than one rating or establish that the lowest rating meet the minimum rating requirements of Part 704.
- Should additional stress modeling tools be required in regulation to enhance credit risk management? Should Part 704 be revised to lessen reliance on National Recognized Statistical Rating Organizations?
- Should Part 704 be revised to provide specific concentration limits, including sector and obligor limits? If so, what specific limits would be appropriate?
- Should corporates be required to obtain independent evaluations of credit risk in their investment portfolios? If so, what would appropriate standards be?

We are not in favor of the current system in the event that the current system is retained then the above conservative safeguards sound reasonable. For the last several years significant emphasis has been placed on the management of interest rate risk and this may have unintentionally resulted in less sensitivity to the mitigation of credit risk. It is important that all levels of risk in a portfolio should be managed and should focus on all aspects of risk.

5. **Asset Liability Management**

- NCUA is considering re-instating the requirement that corporates perform net interest income modeling and stress testing. In addition, NCUA is considering some form of mandatory modeling and testing of credit spread increases.
- The agency is seeking comment on whether NCUA should require corporates to use monitoring tools to identify these trends, including any tangible benefits that would flow from these type modeling requirements.

This would depend on the complexity of the models put forward. But generally yes.

6. **Corporate Governance**

- NCUA is considering minimum standards for directors that would require a director to possess an appropriate level of experience and independence.
- Should term limits be imposed?
- Should directors be allowed to receive compensation?
- Should NCUA establish a category of “outside director”, i.e. outside the credit union industry, not an officer of that corporate, not an officer of a natural person credit union. If such an approach is recommended, should NCUA establish a minimum number of “outside directors” for a corporate?
- Should a wholesale corporate be required to have some directors from natural person credit unions?
- Should compensation be limited to “outside directors” only?
- Should members of corporate credit unions be allowed greater access to salary and benefit information for senior management?

- Term limits should be imposed not more than three 3yr terms or 9 years maximum

- The NCUA should not require board members to be independent of their NPCU or Corporate Board and should not mandate education requirements. This is a cooperative system that should maintain governance by members.

- NCUA should establish a category of "outside director" establish a minority of two "outside directors" for a corporate which would help in representing diverse points of view.

- Directors should not be allowed to receive compensation. If we cannot obtain capable volunteers who can function in conjunction with outside directors then again it seems we missing part of our core cooperative rationale for having corporates or the solution is too complex for my liking.

Other comments on pending issues:

- The credit union movement should NOT seek funds from the federal government, via the Treasury Department to be used as a "backstop" for the NCUSIF. If TARP funds are required the viability of the entire network is threatened.

- Transparent communication with the credit union industry is essential regarding the calculation methodology associated with the newly-imposed deposit insurance premiums. Collaboration with the industry and outside consultants is needed to assure that the assessment is fair / reasonable given the threat this assessment poses to NPCUs.

- CUNA and the corporates are still intertwined. These relationships and contacts hold the potential for conflicts of interest. They should be eliminated. There is some bad history with regard to these types of relationships that have given the movement a black eye in the past.

- Why have you not included suggestions regarding improvement of NCUAs governance of corporates? Are there no NCUA governance issues that contributed to this situation worthy of consideration?

First New England FCU continues to support the continuance of an independent but altered corporate network that is managed in such a way that it does not pose an immediate and substantial risk to NPCUs as the current system now does. While we applaud the steps taken to reexamine the entire system, we also believe that NCUA should devote a greater emphasis to its oversight role and the shortcomings in its structure and governance that contributed to the situation. This can and should be viewed as a positive opportunity to improve as we emerge together from the issues facing us.
